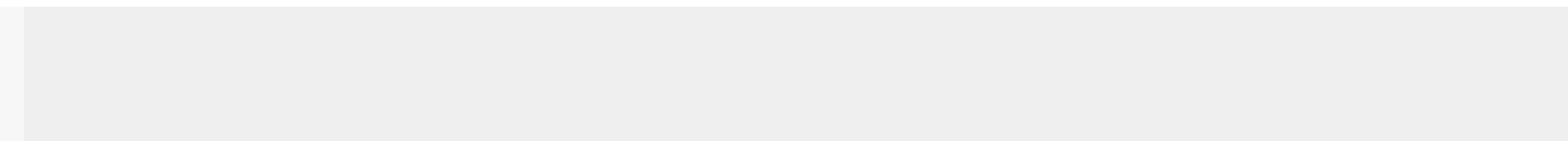# Contract Compliance - Optimizing Vendor Audits

Quick Introduction

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Looking forward to sharing our experiences but also learning from the group.

Presentation Content

The Basics:

- What is a Vendor Audit?

- Key Stakeholders

- Types of Contracts and with Benefits and Drawbacks of Each

The Audit Process:

- Vendor Selection

- Engagement Planning

- Audit Execution and Reporting

- Audit Negotiations and Closure

- ## The Future of Vendor Auditing

What we plan to review over the next hour.

What is a Vendor Audit?

A vendor audit is one method a company can help manage third party risks. It's a retroactive review or audit of vendor billings to verify that they were consistent with the terms of the written agreement between the parties.

Vendor Audit Objectives:

- Finding and recovering overpayments where the intent of the contract was not executed,
- Identifying and implementing process improvement opportunities,
- Review of non-financial contract terms and conditions

Enhancing the transparency between companies and suppliers.

Poll Question

What is your involvement with the Vendor Audit Program?

A. I am involved with the vendor audits in the company and execute on the engagements as a team member or consultant.

B. My company performs vendor audits, but I am not involved in the engagements.

C. My company does not perform vendor audits but is interested in setting up a vendor audit program.

D. My company does not perform vendor audit and at this time.

Key Stakeholders in a Vendor Audit

Vendor audits require coordination between various stakeholders with varying interests and expectations.

- Project Managers in Business;
- Supply Chain;
- Accounts Payable;
- Vendors;
- Legal;
- Senior Management;
- Audit Committee

Enhance transparency between companies and their suppliers

Fixed Fee Contracts (Lump-Sum Contracts)

With a lump-sum contracts, the vendor delivers the project at a <u>preset price</u>. Total price and scope are agreed upon at inception of the contract. Change orders are used to make changes to the initially agreed upon scope.

Benefits

- Works well for projects with a well-defined scope
- Relatively simple contract terms
- Administration and cash flow estimates are easy

Drawbacks

- Aren't usually a good fit for more complicated projects
- They don't factor in changes in material costs, site conditions, or additional requests from the owner

Fixed Fee contracts are best fit for less complex projects where the scope and costs are easily predictable.

Cost-Plus Contracts

Under a cost-plus contract, contractors are paid **all their construction-related expenses** (the cost part of the name) plus a fixed percentage for providing the goods and services. Costs can include:

- Direct costs such as labour, materials, supplies, etc.
- Overheard - insurance, mileage, office rent, etc.
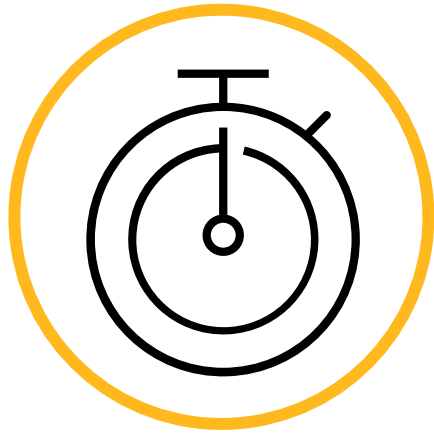
Benefits

- Looked upon favorably by vendors
- Useful when you don't have enough information and scope is not well defined

Drawbacks

- Additional administrative burden to maintain record of labour and materials
- May lead to large overspending on project

Cost-Plus contracts are best fit for more complex projects where the scope and costs are not easily predictable.

Time and Material (T&M) Contracts

Under T&M contracts, the owner pays an agreed-upon rate based on the time spent on the project and required materials. The agreed upon rates include a profit mark-up.

Benefits

- Simple and straightforward
- Helps the company to budget for the overall costs while reducing the risk on the contractor's part in the case of fluctuating material and labor costs
- Provides the company with flexibility to add scope

Drawbacks

- Less transparency about the rate buildup
- May lead to large overspending on project

Time and Material contracts are best fit for more complex projects where the scope and costs are not easily predictable.

Poll Question

Most of the contracts used by my company are:
A. Time & Material
B. Fixed Fee
C. Cost-Plus
D. Mix of all three contracting strategies
E. Unable to quantify due to lack of information from Enterprise Resource Planning system

Vendor Selection

- Risk assess (or prioritize) your vendor audit candidates. Assessment can include:
  - Vendor spend (audit clauses are typically 3 years)
  - Type of contract – Cost-Plus, T&M, Lump-Sum change orders, etc.
  - Contractual terms (audit clause, volume discounts, per diems, etc.)
  - Length of the contract (if ending soon finding negotiation may be more challenging)
  - Review a sample of invoices to determine invoice complexity
  - Time since the last audit
  - Results of similar vendor audits (i.e. inspections companies, construction companies, etc.)
  - Area of the business the vendor is providing work (using the results of previous audits)
  - Feedback from key stakeholders (supply chain, the business, etc.)

Selecting vendors can be an art as company systems may not be mature enough to record all the relevant data required.

Engagement Planning

- Obtain all internally available contract documentation (agreement, terms & conditions, exhibits, appendices, schedules, rate tables, etc.).
- Summarize key terms & conditions and identify potential non-compliance areas – this will build out the audit program (detailed on slide 12).
- Issue an audit notification letter and <u>initial</u> data request to the vendor.
  - List of all invoices with linkage to relevant contract and purchase order (PO)
  - Ask the vendor how their data is available – all electronically (.csv, .xlsx, etc.), PDF, etc.
- Select invoice sample based on data gathered.
  - IF vendor has all invoice and supporting documentation electronically, sample size can be significantly larger (bigger sample size = smaller extrapolations = greater negotiation power).

Planning is an important step in the process and should be allocated 20% to 30% of the engagement budget.

Engagement Planning

- Schedule a kick-off meeting after the detailed data request is made. Agenda items:
  - Introductions,
  - High-level audit process and timing,
  - Review of data requests, and
  - Data gathering controls (OneDrive, etc.)
- Issue a more detailed data request (with invoice sample). Request:
  - All Contact Documentation (to validate internal contract management processes).
  - Invoice and Supporting Documentation – signed Labour, Equipment, and Material Sheets (LEMS), employee timesheets, daily reports, receipts for reimbursed expenses, third party invoices, etc.
  - Labour Information – List of employees and contractors, positions changes, sample contractor agreement, payroll records (if contract supports reviewing), etc.
  - Equipment Information – Details for the list of equipment used to perform work (identifiers, etc.)
  - GPS Data – if available and relevant

Planning is an important step in the process and should be allocated 20% to 30% of the engagement budget.

Poll Question

What should the vendor kickoff meeting consist of?

A. Introductions,

B. High-level audit process and timing,

C. Review of data requests, and

D. Data gathering controls (OneDrive, etc.)

E. All of the above

Engagement Planning

- Build out the engagement audit program. Example tests:

<u>Labour;</u>

✓Rates charged not compliant to contract (rate sheets)

✓Rate buildup includes non-allowable items (bonuses, travel pay, etc.)

✓Rates not consistent with payroll records (only if auditable)

✓Payroll hours inconsistent to billed hours

✓Active rates used for standby hours (equipment too)

✓Excessive labour hours charges (safety standards)

✓Regular and overtime reasonability (overtime charges prior to time requirements)

✓Overburden - CPP, EI, SUTA, FUTA, etc.

✓Employees billed with multiple rates/positions

<u>Equipment and Materials;</u>

✓Rates charged not compliant to contract (rate sheets)

✓Most economical rate not used for equipment

✓Incorrect materials used or does not align with scope (not to agreed specifications)

✓Contract quantities not installed

✓Equipment charges when equipment was not on site

Planning is an important step in the process and should be allocated 20% to 30% of the engagement budget.

Engagement Planning

Other;

- ✓ Duplicate charges
- ✓ Inappropriate markup (third-parties, on tax, etc.)
- ✓ Non-compliant subsistence (per diems, mileage)
- ✓ Volume discounts not applied or calculated incorrectly
- ✓ Input tax credits not applied to per diems
- ✓ Excluded/Ineligible costs billed (items included in rates billed separately)
- ✓ Inappropriate exchange rates

Process Improvements (Internal Process Testing);

- ✓ Does the company have all contract documentation?
- ✓ Are contact amendments being approved appropriately?
- ✓ Do all contracts have an audit clause?
- ✓ If the contractor is working excessive hours, is this a safety issue?
- ✓ Removal of beneficial contract terms?
- ✓ Rates used before effective dates?
- ✓ Are volume discounts being tracked effectively?
- ✓ Are there a large volume of items/positions being charged that are not in the contract?

Planning is an important step in the process and should be allocated 20% to 30% of the engagement budget.

Audit Execution and Reporting

- Execute the audit work program;
  - Complete a spend reconciliation (internal to external)
  - Use data analytic testing when you can
  - Manual invoice testing – document deviations to provide to the vendor
- Preliminary Findings – a list of all "potential" deviations from the contract
  - May require business or supply chain verification (contract interpretation)
  - Actual findings and extrapolations
  - Meet with vendor to review all potential findings – gather their input and ask for potential missing documents
- Draft report – takes into account any additional data provided by the vendor after preliminary findings meeting
- Final report
  - Keep it short – the vendor cares about the contract requirement and the amounts
  - External and Internal versions – internal version to include process improvement findings

Execution is always easier if planning has been rigorous.

Audit Negotiations and Closure

- Industry standard is 20-40% of vendor audit extrapolated findings are recovered
- Have the right people at the table – someone who has the authority to agree to negotiation terms and conditions
- Other alternatives than cash – future volume discounts, longer payment plans, rate discounts in future agreements, a mixture of these, etc.
- Stick to the facts – the vendor will likely be "sensitive" with larger findings
- Document the agreement
- Audit closure letter
- Use the audit results to drive updates to vendor selection and future audit programs
- Maintain sufficient audit records

Reporting is just the beginning of the end.

Poll Question

What do you feel your company needs to work on in order to improve data analytics for Vendor Audit?

A. Our ERP system is not useful in gathering contract information (spend, contract type, etc.)

B. Our contracts do not require standardized electronic invoice data from vendors

C. Our company does not have advanced data analytic applications to run the tests on the data collected (Alteryx, Power Query, etc.)

D. Data Analytics can be used in Vendor Audit?

The Future of Vendor Auditing

- Real-Time Auditing (RTA) – Auditing invoices as they are received before payment
- Electronic Data – 100% audit sampling
  - Requires the contract to stipulate that the vendor provides data electronically (not just in the audit clause)
- Data Analytics (DA) – As data quality increases, the use of DA in vendor auditing improves the efficiency of testing
- Credit Recoveries – Using DA to compare company A/P records to vendor A/R records to identify unclaimed credit memos
- Mini Audits – Quick Win Audits
  - Looking at one risk across several contracts (i.e. ITC not applied to per diems) – can be done on lower spend vendors

Exciting developments are around the corner if we have the courage and stamina to implement them

Q&A